PHILLIPS 66 NATURAL GAS CO.

AND

PHILLIPS PETROLEUM CO.

IBLA 87-181 Decided February 21, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming the assessment of additional royalties and late payment charges. MMS 84-0030-O&G, MMS 85-0021-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties

> An assessment for additional royalties and late payment charges is proper where the holder of an operating interest in part of the lands under lease fails to pay royalties at a rate based upon total lease production, notwithstanding the holder's statement that it sought, and did not receive, lease production data from MMS.

APPEARANCES: Jennifer A. Cates, Esq., T. L. Cubbage II, Esq., Bartlesville, Oklahoma, for appellant; Douglas O. Bowman, Esq., Peter J. Schaumberg, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

Phillips 66 Natural Gas Company and Phillips Petroleum Company (collectively, Phillips) have appealed from a decision of the Director, Minerals Management Service (MMS), dated September 15, 1986, affirming an assessment by the Regional Manager, Tulsa Regional Compliance Office, MMS, of past due royalties 1/ and late payment charges. 2/ The Regional Manager's action relied upon an audit conducted by the Office of Inspector General, U.S. Department of the Interior, which focused upon a number of leases, only one of which need concern us here.

1/ This assessment is set forth in a decision by the Regional Manager dated June 11, 1984.
2/ Late payment charges were assessed by the Regional Manager's decision of Sept. 10, 1984.

Lease 71-031621-B was issued to Harry M. Britt on February 10, 1936, 3/ and a new lease was issued in exchange therefor on May 1, 1956. 4/ Britt is named as lessee in each lease and he continues as record title holder of this lease, which at all times has contained 1,757.04 acres. The parties refer to this lease as a "Schedule D" lease because the royalties which the lessee agrees to pay "on production removed or sold from the leased lands" is set forth on a schedule so designated. This schedule calls for a royalty on gas of 12-1/2 percent of the value thereof when the average production per day for the calendar month is less than 3,000 MCF, and 16-2/3 percent when the average daily production is equal to or greater than 3,000 MCF. This "sliding scale" feature of lease 71-031621-B is the cause of the present appeal.

The record reveals, and Phillips does not dispute, that during the entire audit period (1976-82), average daily production of gas on lease 71-031621-B exceeded 3,000 MCF. It is also well established that Phillips paid royalty at a rate of 12-1/2 percent of the value of gas produced (rather than 16-2/3 percent) for the period January 1980 through December 1982. 5/

Lease 71-031621-B contains four noncontiguous parcels of land in T. 20 S., R. 37 E., New Mexico Principal Meridian, Lea County, New Mexico. As of June 30, 1988, approximately 45 producing wells were located on the leased lands, 6/ and four companies (including appellant) were identified as operators by the New Mexico State Office, Bureau of Land Management. At all relevant times, Phillips was the holder of a one-half interest in the SE^ SW^ sec. 5 and the NE^ NE^, S\ NE^, and SW^ sec. 18, T. 20 S., R. 37 E., New Mexico Principal Meridian, pursuant to an operating agreement originally entered into by Britt.

Phillips responded to the Regional Manager's assessment of June 11, 1984, by stating its production from lease 71-031621-B did not exceed 3,000 MCF per day for any month and that Phillips did not have access to, or the right to obtain, production information from the other wells subject to the lease. Appellant stated that MMS should advise it on a monthly basis of the total production from the lease so that it might determine the proper royalty percentage on a current basis and avoid retroactive corrections. Because it did not have access to the total production from lease 71-031621-B and because MMS structured both the lease language and the

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3/ Prior to this date, Britt held oil and gas prospecting permit Las Cruces 031621, issued Nov. 11, 1926. From the area within this permit, 2,315.05 acres, more or less, the Acting Secretary authorized issuance of two leases, Las Cruces 031621(a) and (b). MMS advises that the prefix "71" in the lease on appeal appears to be a code for royalty management purposes.

4/ This exchange lease was issued pursuant to 30 U.S.C. | 226(i) (1982).

5/ Audit Report, Office of Inspector General, February 1984, at 12, set forth as attachment D to Memorandum, dated Aug. 23, 1984, from the Regional Manager to the Chief, Division of Appeals.

6/ Response of MMS, Oct. 24, 1988, at attachment 8.

division of leased interests, Phillips stated, 7/ a late payment charge was not appropriate for its underpayments in this situation.

In a prior letter to MMS, 8/ appellant explained that it sought direction from the auditors as to how it could obtain information necessary to determine whether its royalty rate was 12-1/2 percent or 16-2/3 percent. The auditors were unable to answer this question, Phillips stated. Phillips also argued that because possible antitrust implications arise when a party seeks to obtain certain information concerning leases owned and operated by a competitor, the only legal way to obtain the information would be through MMS. Phillips concluded its discussion of lease 71-031621-B by seeking guidance from MMS as to how it could avoid future royalty underpayments.

The Director's decision of September 15, 1986, from which the present appeal is taken, focuses almost exclusively on issues no longer before the Board. 9/ The Director does, however, state that Phillips could have determined whether output exceeded 3,000 MCF per day by a simple calculation based upon Phillips' knowledge of its working interest and its output. 10/ As to the late payment charges assessed to appellant, the Director stated the MMS policy, as reflected in 30 CFR 218.102 and its predecessor provisions, of assessing late payment charges for failure to pay royalties timely. Such charges are not a penalty, the Director stated, but they arise from bona fide expenses, are equivalent to the time value of money, and are intended to compensate for the replacement costs of funds due but not paid in a timely manner.

In its statement of reasons on appeal of the Director's decision, appellant contends that MMS cannot properly assess it for either late payment charges or past due royalties because MMS denied appellant's requests for the production figures necessary to determine the proper royalty rate. Appellant further contends that MMS had no basis to impose a late payment charge prior to the October 1982 publication of final rules authorizing such penalties.

[1] The primary facts we look to in this decision are not in dispute. The lease calls for a royalty on gas of 12-1/2 percent of the value thereof when the average production per day for the calendar month is less than 3,000 MCF, and 16-2/3 percent when the average daily production is equal

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7/ Notice of Appeal, July 13, 1984, at 2.

8/ See attachment C to Memorandum, dated Aug. 23, 1984, from the Regional Manager to the Chief, Division of Appeals.

9/ By order of Sept. 7, 1988, the Board granted a motion by MMS and Phillips to dismiss this appeal as to seven leases for which no dispute remained.

10/ In a memorandum to the Chief, Division of Appeals, dated Aug. 23, 1984, the Regional Manager stated that Phillips, as lessee of 71-031621-B, was entitled to gas production information. Such information was generally public information, the Regional Manager stated, and was published by several organizations in the business of providing petroleum operations and production information. Id. at 3.

to or greater than 3,000 MCF. During the entire audit period (1976-82), average daily production of gas on lease 71-031621-B exceeded 3,000 MCF. Phillips paid royalties at the 16-2/3 percent rate until January 1980, and paid royalties at a rate of 12-1/2 percent during the period January 1980 through December 1982. There can be no doubt that Phillips underpaid royalties during the period from January 1980 through December 1982 by 4-1/6 percent.

Phillips was operating under a lease which called for the payment of royalties at one of two rates depending upon the rate of production from the leased lands. It was therefore faced with taking one of two alternatives
if it was of the opinion that average daily production may be less than 3000 MCF. The first was to pay the royalty at the higher rate and seek a refund. The second was to pay royalties at the lower rate, assuming the consequences of a subsequent determination that they had been underpaid. In January 1980, Phillips opted to reduce the royalty from 16-2/3 percent to 12-1/2 percent, thus taking the second course of action.

The first consequence of having paid the lower rate is that upon audit Phillips was correctly found to have underpaid the royalty by 4-1/6 percent and was called upon to remit that amount. On appeal Phillips claims that
it does not owe the additional royalties because of MMS' failure to advise Phillips that the royalties were to be paid at a higher rate. In support
of this position, appellant cites Shear v. National Rifle Association of America, 606 F.2d 1251 (D.C. Cir. 1979), and Westinghouse Electric Corp. v. Garrett Corp., 437 F. Supp. 1301 (D. Md. 1977), aff'd, 601 F.2d 155 (4th Cir. 1979). Upon review of these cases, however, we find that neither case supports the position that when the critical data ultimately becomes known to the party promising performance (Phillips in this case), the promisor may continue to enjoy the benefits of the bargain and yet refuse to give value therefor.

In the present case, the benefit of the bargain is the production
of gas, and the value afforded the lessor is the payment of royalties. Phillips assumed the obligation to compensate the Federal Government for the gas Phillips produced from the leased lands. The lease agreement specified the consideration to be paid. When Phillips severed the gas from the realty and retained ownership of that gas it incurred a contractual obligation to pay the royalties upon that gas. The Federal Government had fully performed its obligations under the lease agreement with respect to the gas Phillips had severed from the land. Phillips was at no time relieved of the responsibility to fully compensate the Federal Government for the gas it had severed from the land while operating under the lease. In such case it is proper for a contracting party to seek payment of the amount owing. See Restatement of Contracts 2d | 345(a). We find no basis for a holding that Phillips properly paid royalties at the lower rate.

We now turn to the question of whether MMS can properly assess a late payment charge for underpayment of royalties. The general authority to exact late payment charges is clear. These charges were authorized by

30 CFR 221.80 (1981), effective February 1, 1981. 45 FR 84762 (Dec. 23, 1980). All charges assessed to appellant began in March 1981. 11/

Phillips contends that a late payment charge is not appropriate because it did not have access to information necessary for a determination of the total production from lease 71-031621-B during any given month, because of MMS' failure to advise Phillips that the royalties were to be paid at a higher rate, and because MMS structured both the lease language and the division of leased interests.

Phillips initially argued that because possible antitrust implications arise when a party seeks to obtain certain information concerning leases owned and operated by a competitor, the only way to obtain the information would be through MMS. 12/ On appeal appellant concedes that an antitrust violation should not result from an inquiry for production data. 13/ It maintains, however, that operators are reluctant to provide such data because of their concern over antitrust implications. Nowhere in the record, however, does Phillips allege that it sought and was refused this data in the instant case. 14/

Phillips also contends that it sought production data from MMS and
was rebuffed. However, our review of the record indicates that the only requests made by Phillips occurred after the audit period had passed. 15/
At the time Phillips sought this information the amount representing the 4-1/6 percent royalty owing from production during the audit period was
long overdue. Moreover, there is no showing in the record that Phillips sought any advice as to the correctness of reducing the royalty rate to 12-1/2 percent at the time it commenced paying royalties at the lower rate. Nor does Phillips demonstrate that information generally available to the public is not sufficiently detailed to allow Phillips to make a reasonable prediction, based upon the history of prior production, that the average daily output from the lease exceeded 3,000 MCF in any given month.

The record does not support appellant's contention that MMS was its sole source for the necessary production data or that MMS somehow prevented appellant from properly performing its royalty payment obligations in a manner which would in some way preclude MMS from now seeking late payment charges. On the other hand, the evidence in the record would support a finding that Phillips chose to take a reasonable business risk that the

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11/ See attachments to decision of the Regional Manager, Sept. 10, 1984, assessing late payment charges.
12/ The record shows that one company, Conoco, is the operator of almost all the wells on lease 71-031621-B.
13/ Reply to Answer, June 5, 1987, at 13.
14/ The record does show that when Phillips sought production data from interested parties in leases 71-029415-B and 71-028772-B, leases no longer at issue here, such data was readily provided. Reply to Answer, June 5, 1987, at attachment E.
15/ See Statement of Reasons, Feb. 2, 1987, at 22; Reply to Answer, June 5, 1987, at 10 and at attachment A.

proper interpretation of the lease was that the royalty rate would be 12-1/2 percent if its production from the lease did not exceed 3,000 MCF on a daily average basis. Its interpretation was incorrect and it must bear the consequences.

Assuming, arguendo, that MMS was the sole legal source available to appellant for obtaining the data necessary to allow appellant to determine whether daily production from lease 71-031621-B exceeded 3,000 MCF during a given month, we find no basis in the record for concluding that, under the present scheme of reporting and payment, MMS could receive the necessary production data from all of the various operators under lease 71-031621-B and relay that information to Phillips before its payment deadline. As the appellant, Phillips bears the burden of showing error in the Director's decision. Bender v. Clark, 744 F.2d 1424 (10th Cir. 1984). Its failure to offer evidence that the reporting and payment deadlines required of an operator would permit MMS to give notice of the total production from the lease in time for Phillips' adjustment of the royalty rate precludes our finding that any recalcitrance on MMS' part caused appellant to underpay the royalties when due. We find the late payment charge was properly assessed.

In light of our holdings herein and there being no material fact at issue, appellant's request for a hearing is denied.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director is affirmed.

R. W. Mullen
Administrative Judge

I concur:

Anita Vogt
Administrative Judge
Alternate Member